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WHAT THE CRASH MEANS FOR YOUR RETIREMENT

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By the end of the first quarter of 2001, the stock market bubble of the late 1990s had burst. Compared to a year earlier, the Dow Jones had dropped 10%, the S&P 500 23%, and the NASDAQ 60%. The implications for the financial wealth of households are staggering:

- The bursting of the stock market bubble has meant the largest absolute decline in household wealth since World War II, even after correcting for inflation.
- In relative terms, the markets' drop represents the sharpest decline in household wealth in about 25 years, suggesting that a huge drop in the stock market can occur more than once during one's working life.
- Recovering from such losses in financial wealth can take years or decades. If income and wealth were to grow at historical rates, the relative wealth position of households would not recover its level of early 2000 for the next 25 years.

The impact of such a drastic decline in market value, restricted now to households with significant stock holdings, would be nearly universal under a privatized Social Security system. If the market took a substantial hit while nearly all households had a portion of their retirement funds invested in the stock market, it is extremely unlikely that a recovery would occur in time to help people anywhere close to retirement age.

President Bush has convened a commission to examine reforming Social Security by allowing Americans to invest part of their payroll taxes in private retirement accounts. The recent downturn in the stock market points to the risks to future retirees of transforming Social Security from a program that insures against poverty to one that incorporates an unnecessary level of risk.

The stock market and household wealth

According to the latest statistics from the quarterly Flow of Funds Accounts of the Federal Reserve Board, released in March 2001, the direct holdings of stocks by households declined by $2.2 trillion in nominal terms from the end of 1999 to the end of 2000, a drop of 24%. Part of this decline can be attributed to households selling their shares and putting their money into other financial assets, such as certificates of deposits, mutual funds, and so on, rather than the fall in prices. But the decline in the value of directly held equities is not the only place where households have felt the losses from the bursting bubble. In particular, the value of mutual fund shares and pension fund assets also declined as a result of a substantially weaker stock market. Thus, we need to consider what happened to the total financial assets of households.

In nominal terms, the total financial assets of households decreased by 5%, or $1.7 trillion, from the end of 1999 to the end of 2000. After correcting for inflation, the decline was 8%, the largest drop since the end of 1974.

At the same time that households were losing money on their financial assets, they were increasing their debt. Total financial liabilities of households rose by $600 billion in 2000, a 9% nominal increase over the year before.

With assets falling and liabilities rising, the financial wealth of households fell substantially. In nominal terms, the drop totaled $2.3 trillion, or 8%, between the end of 1999 and the end of 2000; in real terms financial wealth dropped $1.9 trillion, or 11%. In absolute terms, these are the largest declines since World War II; in relative terms, these are still the biggest drops since the end of 1974.

The implications for retirement wealth

More important than the absolute level of household financial wealth is the relative size of financial wealth. In particular, financial wealth needs to be seen in relation to the income of households. Most of the financial assets accumulated by households are intended to provide retirement income security. As incomes go up, so should the wealth held by households in order to provide sufficient retirement income. If financial wealth does not increase in line with income, then households will likely face a substantial deterioration in their income situation by the time they retire.

Financial wealth relative to personal disposable income declined significantly in 2000. By the end of the year, the net worth of households was equal to 369% of their personal disposable income, the same as in the third quarter of 1998. In other words, the stock market declines in the latter part of 2000 eliminated all of the gains of the previous year and a half, during which time the stock market grew well above average.

Fluctuations in the stock market are an inherent part of risky equity investments. Because equities are riskier than other investments, investors are supposed to be rewarded for holding riskier assets. How long will it take households to recover the losses in their financial wealth if the stock market begins to grow again?

Assuming that personal disposable income remains at its current level of 70% of gross domestic product, that GDP grows at 3% above inflation, that inflation averages 3%, and that total financial net worth of households increases at an annual rate of 3.5%, then raising the financial wealth of households to 380% of personal disposable income will take about six years, to 390% will take almost 12 years, and to 423% (the level of the first quarter of 2001) about 28 years. Even these dire projections for recovery assume that financial net worth rises faster relative to personal disposable income than it has in the past.

Historically, it has taken quite some time for households to recover their wealth positions after the stock market declined. For example, the financial wealth of households relative to their personal disposable income declined from a high of 294% at the end of 1972 to a low of 229% by the end of 1974. It took more than 20 years (until the third quarter of 1995) for households to return to a level above 294%.

Conclusion

Major declines in the stock market are not unheard of—they tend to occur at least once every generation. And recovery from losses in the stock market can take years or even decades, which individuals close to retirement do not have. Increasing the exposure of households to the volatility of the stock market is a dangerous policy proposal that will only serve to diminish retirement income security for current workers and future retirees.